What is a Business Development Company?

Portfolio diversification is more important than ever, and is harder to find as bonds and equities exhibit higher correlations. Business development companies have come into view as a potential solution for complementary income and diversification.

A Brief History Lesson

The story of Business Development Companies (BDC) begins back in the early 20th century with the creation of the investment company. An investment company is a company whose main business is investing money on behalf of their clients who, in return, share in the profits and losses. Congress passed a set of laws in 1940 called the Investment Company Act of 1940 (the '40 Act) to govern these companies and protect the interest of investors.

By the late 1970s, large businesses began to grow to sizes that challenged the once great spirit of American entrepreneurialism and lawmakers saw the need to help stimulate small and growing private companies. To address these concerns, Congress signed an amendment to the '40 Act; The aptly named "Small Business Investment Incentive Act of 1980." This amendment created a new type of registered investment company, the Business Development Company, or BDC.

Rise to Prominence

Although the regulation which brought the BDC into existence passed in 1980, most early adopters were private and internally managed. Internally managed BDCs employ and compensate employees like typical operating companies, relying on cash and stock option plans to incentivize management personnel. In 2004 BDCs came roaring to the forefront with the listing of the first publicly traded BDC. Following this success, the industry focus shifted to externally managed BDCs and a steady stream of BDC IPOs hit the market seeking to follow suit. Generally, externally managed BDCs do not have employees; they are instead operated by third-party investment advisers and administrators like mutual funds and traditional closed-end funds.

The 2007 financial crisis and subsequent regulatory changes created an opportunity for BDCs. With banks forced to reduce the liabilities on their balance sheets, small and middle market companies were left to search for other sources of financing.

How do BDCs Work?

BDCs provide private companies with access to financing by raising money from the public and investing it in a portfolio of private companies. The vast majority of BDCs invest primarily in debt securities, usually in the form of bonds and loans. Interest payments on these bonds and loans are collected by the fund and passed through to shareholders in periodic distributions, positioning shareholders as lenders to private companies in a capacity previously reserved for institutions and high net worth individuals.

BDCs may help provide investors with a complementary source of income from the traditional suite of corporate, municipal and government bonds. Most BDC portfolios are concentrated in senior secured loans and bonds, which have repayment priority in the event of a default, ahead of subordinated debt and equity holders. These loans are typically to private companies considered below-investment-grade, which means that they may be more illiquid and cumbersome to value and experience higher default rates compared to investment-grade companies. BDCs seek these investments due to the increased yield associated with illiquid securities, which should be weighed against the level of risk assumed with such investments.

Regulatory Requirements

BDCs designation as Registered Investment Companies (RICs) under the '40 Act means they must meet specified requirements regarding their source of income and diversification of assets. RICs must derive a minimum of 90% of their income from capital gains, interest or dividends earned on investments. RICs also must distribute a minimum of 90% of net investment income in the form of interest, dividends, or capital gains to their shareholders.

All BDCs must also meet the below requirements:

- Must have majority-independent board of directors
- Must value assets at least quarterly
- Must file periodic reports with the SEC (e.g., Forms 10-K, 10-Q and 8-K and proxy statements)
- Must appoint a chief compliance officer (who reports to the board) and maintain compliance procedures designed to prevent violations of federal securities laws
- Must maintain a fidelity bond to insure the BDC against larceny and embezzlement.

Risks

As with any investment, there are certain risks associated with business development companies (BDCs) as well as with the underlying assets they contain. Publicly traded BDCs have volatility risk exposure but offer liquidity while non-traded BDCs are considered illiquid which can offer illiquidity premiums. BDCs may contain equity or debt investments but are usually associated with the latter such as high-yield bonds or levered loans. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Although costs can vary from one BDC to the next, they can involve substantial costs. We urge anyone considering this type of investment to review the corresponding product prospectus for this information regarding fees and expenses.

To learn more about Business Development Companies, please contact your financial professional.